Medium Term Outlook for the Swedish Economy

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Kristian Nilsson

NIER

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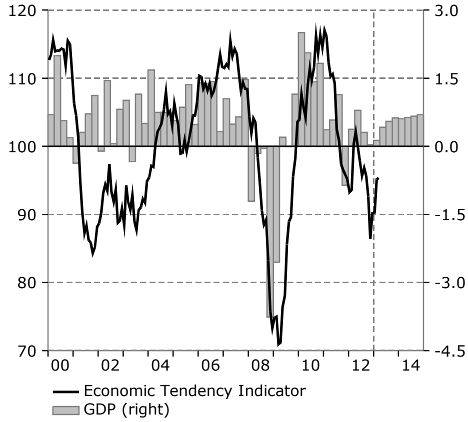
Medium term outlook for the Swedish Economy

Swedish GDP grew by a meager 0.8 percent in 2012 and the output gap widened to –2.3 percent. The Swedish economy is highly dependent on the development in rest of the world. The sluggish recovery in the OECD area will be a factor in making domestic demand more important than normal for Sweden's recovery. This calls for an expansionary economic policy. Fiscal policy will have an expansionary stance in 2013. In the NIER's analysis, fiscal policy will be virtually neutral next year. But since cyclically adjusted net lending will be negative in 2014, a tighter fiscal policy 2015–2017 will be necessary for meeting the surplus target. With the low level of resource utilization, low inflation and low interest rates in other countries, the Riksbank will not raise the repo rate until 2015.

The Swedish economy is highly dependent on the development in rest of the world. Swedish exports amounts to 50 percent of GDP. The financial sector has a strong international exposure and is relatively large, with total assets amounting to some 400 percent of GDP, i.e. twice as much as the EU average.[1] When the financial crisis struck the world economy in 2008–2009 the Swedish economy was in good shape, with sound public finances, strong private sector balance sheets, a healthy financial sector and a business sector with a strong international competitiveness. But weakening international demand resulted in a dramatic fall in exports. Soon also domestic demand weakened and confidence indicators plummeted to historically low levels (see Diagram 1). Moreover, fears arose concerning the sustainability in the foreign parts of the banking system, most notably in the Baltics. GDP fell by 1 percent in 2008 and by a full 5 percent in 2009. On aggregate, this was a substantially bigger fall than the OECD average.

Diagram 1 Economic Tendency Indicator and GDP

Index mean=100, monthly values and percentage change, seasonally adjusted quarterly values, respectively



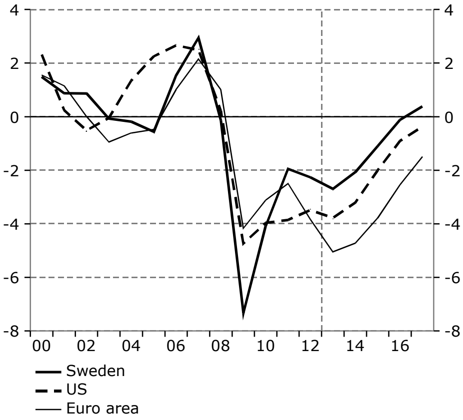
Sources: Statistics Sweden and NIER.

In 2010 the economy bounced back with a stunning growth of more than 6 percent, as the global financial turmoil eased of a bit and international trade and global growth recovered. Since then economic growth has fallen back, the main reason being a once again weaker development of the global economy. The debt crisis in the euro area has led to financial market turbulence, a weak macroeconomic development and sweeping fiscal austerity measures, primarily in southern Europe. Swedish exports of goods have suffered from a weakening in demand. Uncertainty about the resolution of the crisis has also contributed to the lacklustre development of domestic demand as Swedish households and firms have been holding back on consumption

[1] See *Financial Stability Report 2012:2*, Riksbanken, available on www.riksbank.se.

Diagram 2 Output Gap

Percent of potential GDP



Sources: OECD, IMF and NIER.

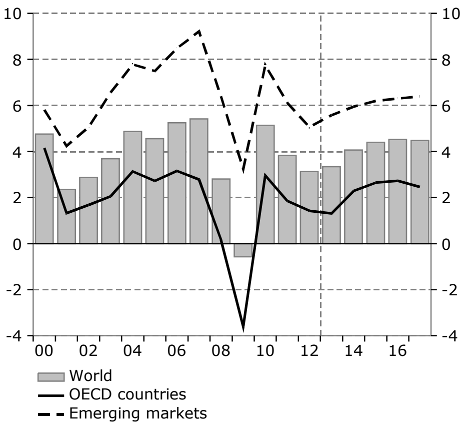
and investment. As a consequence, the resource utilization in Sweden is still low and the output gap is estimated to be around –2 percent of potential GDP in 2012 (see Diagram 2).

GLOBAL RECOVERY TAKES LONG TIME

The relatively weak global growth in 2012 continues this year. Although an upturn is expected during the second half of this year, the global economy will recover only slowly in 2014–2017, partly due to the limited margin for further economic policy stimulus (see Diagram 3 and Table 1).

Diagram 3 GDP World-wide, in OECD Countries and Emerging Markets

Percentage change



Note: Emerging markets here refer to all non-OECD member countries.

Sources: OECD, IMF and NIER.

Table 1 GDP and CPI World-wide

Percentage change

	2012	2013	2014	2015	2016	2017
GDP, OECD	1.4	1.3	2.3	2.6	2.7	2.5
GDP, emerging markets[1]	5.1	5.6	5.9	6.2	6.3	6.4
GDP, world-wide	3.1	3.3	4.1	4.4	4.5	4.5
CPI, OECD	2.2	1.9	2.0	2.0	2.1	2.2
CPI, world-wide	3.9	3.7	3.7	3.7	3.6	3.6

[1] The term emerging markets here denotes all non-OECD member countries.

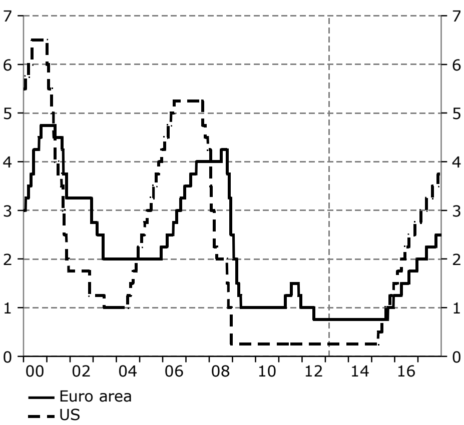
Note. GDP figures are calendar-adjusted and in constant prices. Aggregates are calculated using purchasing-power adjusted GDP weights from the IMF.

Sources: IMF, OECD and NIER.

Global resource utilization will remain low for years to come. This means that the development of prices will be subdued, not least in many OECD countries. Consequently, central banks in the OECD area can continue to support demand through an expansionary monetary policy in the next few years (see Diagram 4).

Diagram 4 Policy Rates

Percent, daily values



Sources: ECB, Federal Reserve and NIER.

The sluggish global recovery will hold back the recovery in Sweden. Relatively favorable domestic conditions, however means that resource utilization will rise somewhat faster in Sweden in comparison with the OECD average. Hence, the output gap in Sweden is expected to close by late 2016, whereas it takes a bit longer to close the output gap in many OECD countries (See Diagram 2).

WEAK DEVELOPMENT OF POTENTIAL GDP IN SWEDEN[2]

During 1980–2012 potential output in Sweden grew by an average of 2.3 percent per year according to NIER's assessment. However, during the economic downturn in recent years growth in potential GDP has slowed markedly. Underlying the weak tendency is a slow rate of increase in productivity. Growth in potential GDP is expected to pick up gradually 2013–2017 (see Table 2).

[2] All figures on the real economy are calendar-adjusted unless otherwise indicated.

Table 2 Potential Variables

Percentage change unless otherwise stated

	2012	2013	2014	2015	2016	2017
Potential GDP	1.5	1.7	1.8	2.0	2.1	2.1
Potental hours worked	0.8	0.5	0.5	0.5	0.5	0.5
Of which potential employment	0.7	0.6	0.5	0.5	0.5	0.4
Of which demografic contribution	0.4	0.4	0.4	0.4	0.3	0.3
Potential productivity	0.8	1.2	1.3	1.4	1.6	1.6
Potential productivity, business sector	1.5	1.5	1.6	1.8	2.1	2.1

Note. The calculations are calendar-adjusted.

Sources: Statistics Sweden and NIER.

Slow growth in productivity

Productivity growth has slowed dramatically in Sweden in recent years, just as in many other OECD countries. In Sweden, productivity in the business sector on average rose by 2.6 percent per year during 1980–2007. From 2007 to 2012 the corresponding figure was a meagre 0.5 percent per year. This downward shift is partly cyclical, but it also reflects a shift in the development of the underlying trend. The weak tendency in growth of potential productivity in the business sector is expected to continue for some years, one reason being a modest need for capacity-enhancing investments, holding back the introduction of new technology. In 2016–2017, potential productivity growth rate in the business sector is expected to reach 2.1 percent, close to NIER's assessment of the long-term annual growth rate of 2.3 percent (see Table 2). This assessment is for obvious reasons quite uncertain and it constitutes one of the main risks to the medium-term forecast.

Labour market reforms boost labour supply

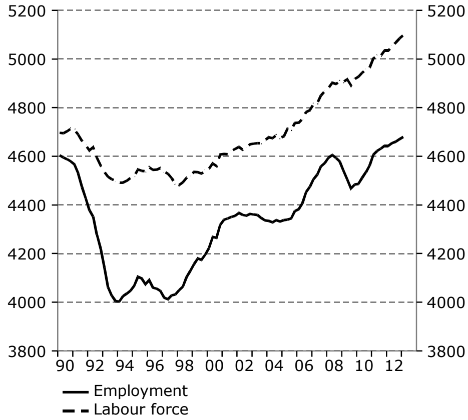
The Swedish labour market has surprised on the upside in recent years. From 2007 to 2012 employment rose by 2.6 percent, in spite of the economic downturn (see Diagram 5). However, the labour force has grown even more. Unemployment has picked up and in 2012 it stood at 8.0 percent (see Diagram 6), which is slightly more than one percentage point higher than the NIER's assessment of the equilibrium unemployment rate that year.

The employment rate (20 to 64 years) in Sweden was close to 80 percent in 2012, i.e. roughly the same level as in 2007 before the economic downturn. In a European context this is high (see Diagram 7). As the Swedish recovery proceeds, the employment rate will gradually rise further to some 81 percent.

The rapid increase of the labour force is partly a demographic effect. But it is also attributed to a number of reforms on the labour market, in the social insurance system and in the tax system. These reforms are aimed at increasing potential employment, using both carrots and sticks. The most important

Diagram 5 Labour Force and Employment in Sweden

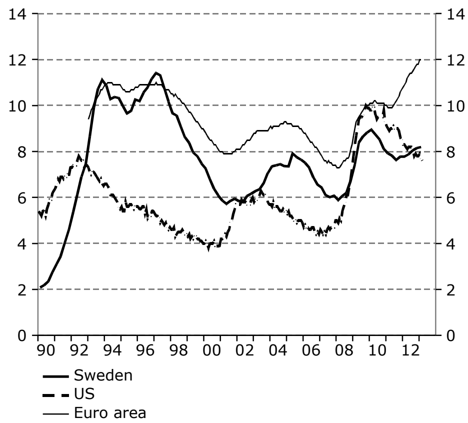
Population 15–74, thousands of persons, quarterly values



Sources: Statistics Sweden and NIER

Diagram 6 Unemployment

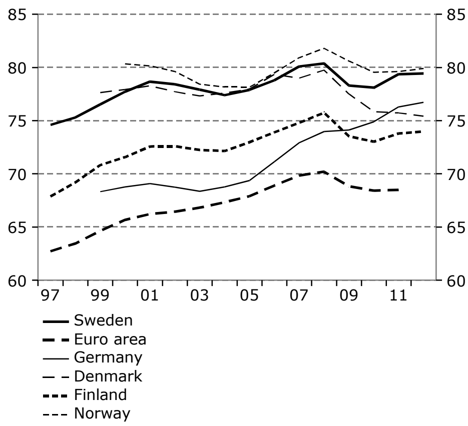
Share of labour force, percent, quarterly values



Sources: Statistics Sweden, NIER, Eurostat and Bureau of Labour Statistics

Diagram 7 Employment Rates

Percent of population aged 20–64



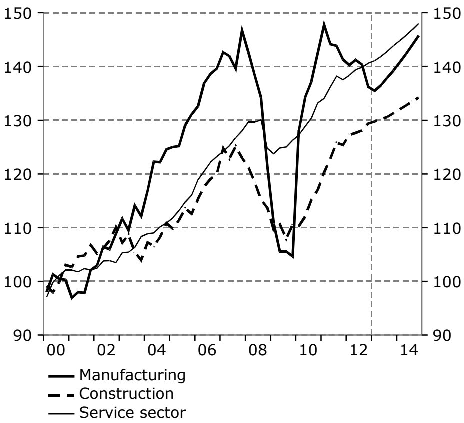
Source: Eurostat

reforms in this respect are an earned-income tax-credit, changes in the unemployment and sickness insurances and tax credits for some household services.[3] In the long run these reforms are expected to boost labour supply by 2.6 percentage points and lower the equilibrium unemployment rate by 1.1 percentage points. The long run effect on potential employment is thus expected to be 3.7 percentage points.

According to NIER, most of the effects on the labour force have by now materialised. The potential labour force increased with 5 percent between 2007 and 2012, of which the reforms explain about half. The effect on the equilibrium unemployment rate is expected to feed through more gradually, since changes in behaviour of firms and the labour market parties take long time. This means that potential employment will rise a little faster in 2013–2017 compared to what is motivated by demographic changes alone (see Table 2).

Diagram 8 Production Volume in Selected Trades and Industries

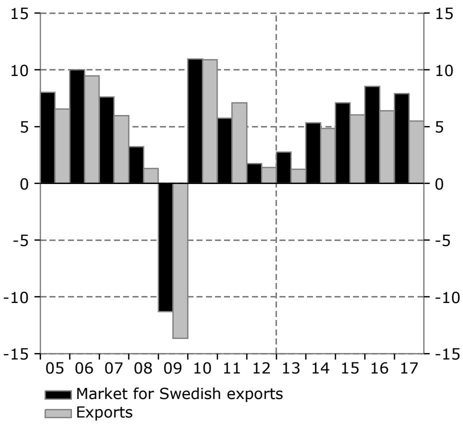
Index 2000=100, seasonally adjusted quarterly values



Sources: Statistics Sweden and NIER.

Diagram 9 Swedish Export Market and Exports

Percentage change



Sources: IMF, OECD, Statistics Sweden and NIER.

RECOVERY TO BEGIN IN THE SECOND HALF OF 2013

Economic indicators imply that aggregate demand will still be weak in the first half of 2013. Growth in demand will be curtailed in the immediate future primarily by fiscal austerity measures in other countries and continued uncertainty about the manner in which the euro crisis will be resolved. In NIER's assessment the uncertainty will diminish during the current year. As this happens, the Swedish economy will be well prepared for recovery. Household saving is high, thus permitting consumption to increase as uncertainty subsides. Moreover, capacity utilization is very low in the manufacturing sector. Production is substantially lower than it was five years ago and output may be increased rapidly (see Diagram 8).

The drawn-out international recovery means that domestic demand will have to drive recovery in Sweden to a greater extent than what has been the case in recent recoveries. In the period ahead, domestic demand is expected to grow faster than GDP and the service sector will continue to be an important driver of growth (see Diagram 8). To support this development, monetary policy will need to be expansionary. But it might prove difficult to stimulate domestic demand sufficiently.

FALLING NET EXPORTS AS A SHARE OF GDP

The prolonged recovery of the global economy means that the market for Swedish exporting firms will be growing comparatively slowly this year (see Diagram 9). This will be a factor in the slow growth of Sweden's exports, only 1.2 percent in 2013 (see Table 3). The weak export growth is to some extent also a consequence of strengthening of the Swedish krona in recent

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[3] The reforms and NIER's assessment of their impact on the economy are presented in-depth in the special analyses "Long-Term Effects of Economic Policy Reforms on the Labour Market" and "The NIER's Assessment of Equilibrium Unemployment", both available on www.konj.se (english version).

years, particularly vis-à-vis the euro (see Diagram 10). In coming years the krona is expected to be fairly stable vis-à-vis the US dollar and the euro. The stronger krona will continue to weigh a bit on exports in coming years. From 2014 and on, exports will increase faster, but still not keep up with the growth of the market for Swedish exports (see Diagram 9)

Sweden has long had a large surplus in net exports. There are several factors to explain why this surplus has developed. The proportion of the Swedish population outside working-age in the total population fell from the early 1990's until around 2003 (see Diagram 11). These age groups in general save less than working-age people. The demographic development has thus fuelled household saving. Together with the implementation of the surplus target for general government net lending (1 percent of GDP over the business cycle) in the year 2000 and a reformation of the pensions system a year earlier (from a pay-as-you-go system to a partly funded system), this contributed to a substantial build up in the net financial savings position vis-à-vis other countries. The flip-side of this was surging net exports, which peaked at 8 percent of GDP around 2005 (se Diagram 12).

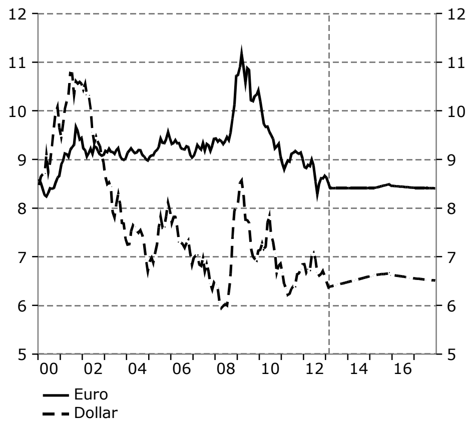
Since then net exports as a share of GDP has fallen somewhat, partly for cyclical reasons. But the downturn has coincided with a turnaround in the demographic development, with a rising proportion of population outside working-age. Going forward, the proportion of younger and older persons will continue to increase. Household saving is therefore expected to show a downward trend and Sweden's net financial savings in relation to other countries is expected to decrease in the period ahead. This development will be supported by the need in particularly some European countries to improve their financial savings position. Hence, it is expected for Swedish net exports to continue to fall as a share of GDP (see Diagram 12).

CONSUMPTION AND INVESTMENT TO DRIVE RECOVERY

Growth in household consumption was a modest 1.7 percent in 2012. This outcome was due to continued high precautionary saving, which is largely explainable by the uncertainty over how the euro crisis will affect the Swedish economy. Toward the end of 2012, however, growth in household consumption expenditure increased and consumer confidence is on the rise (see Diagram 13). This marks the beginning of a period of higher growth in household consumption expenditure. In 2013, though, the upswing will be curbed somewhat by rising unemployment. Thereafter the growth rates will be higher (see Diagram 14). This means that growth in consumption per capita will be relatively high during these years (see Diagram 15).

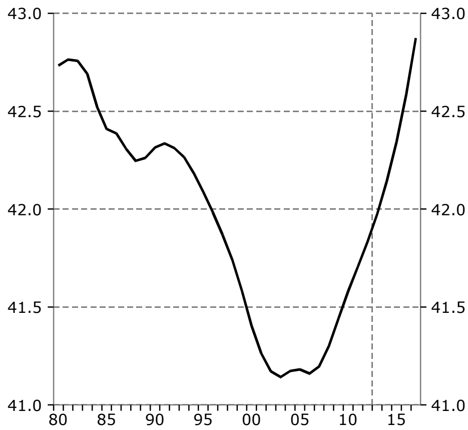
There are several reasons for the relatively strong growth in consumption. First, the saving ratio is high to begin with, enabling households to increase their consumption (see Diagram

Diagram 10 Exchange Rates
SEK per currency unit, monthly values



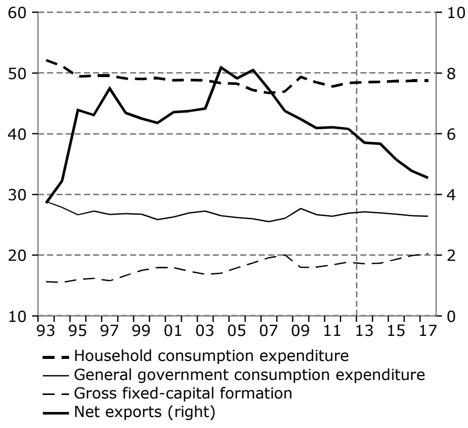
Sources: The Riksbank and NIER.

Diagram 11 Population Outside Working Age (0–19 and 65+)
Share of total population, percent



Sources: Statistics Sweden and NIER

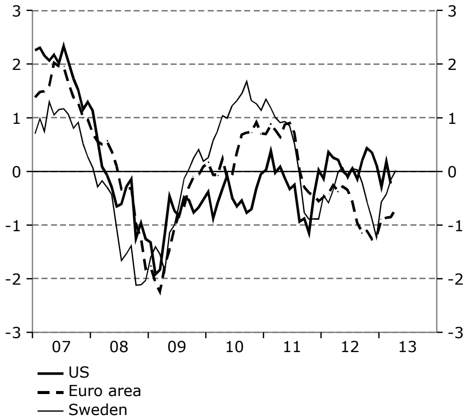
Diagram 12 Demand Components
Percent of GDP, current prices



Sources: Statistics Sweden and NIER.

Diagram 13 Consumer Confidence in US, Euro Area and Sweden

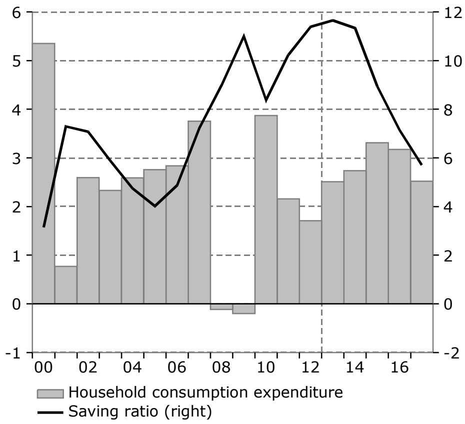
Standardized deviations from mean, monthly values



Sources: Conference Board, Eurostat and NIER.

Diagram 14 Household Consumption and Saving Ratio

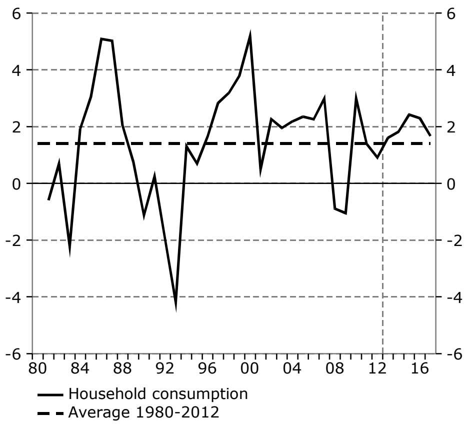
Percentage change and percent of disposable income, respectively



Sources: Statistics Sweden and NIER.

Diagram 15 Household Consumption per Capita

Percentage change



Sources: Statistics Sweden and NIER.

14). Second, recovery in household consumption expenditure will be stimulated by low interest rates. But fiscal policy is assumed to be contractionary in 2015–2017, curtailing household consumption somewhat.

General government consumption will increase by an annual average of 1.1 percent in 2013–2017 (see Table 3). Growth in general government consumption will be higher toward the end of the period, partly because demography spurs the demand for public services, and partly because local government finances will improve as the economy strengthens.

Gross fixed capital formation dropped sharply in 2009. Despite a strong recovery, particularly in 2010 and 2011, gross fixed capital formation as a share of GDP was only 18.8 percent in 2012 (see Diagram 12). This is below NIER's assessment of the long run equilibrium level of 20 percent as a share of GDP. In 2013 growth in gross fixed capital formation softens again, as residential investments and investments in the manufacturing sector falls. A pent up demand for investments will develop and in 2014–2017 gross fixed capital formation will increase quite rapidly.

All factors considered, this means that GDP growth will gradually increase to a bit more than 3 percent per year in 2015–2016 (see Table 3). Not until 2016 will resource utilization, as measured by the output gap, be in balance (see Diagram 16).

Table 3 GDP by Expenditure

Percentage change, constant prices, calendar-adjusted values

	2012	2013	2014	2015	2016	2017
Household consumption expenditure	1.7	2.5	2.7	3.3	3.2	2.5
General government consumption expenditure	1.3	1.0	0.9	1.1	1.2	1.4
Gross fixed capital formation	4.0	1.3	3.8	6.9	6.9	4.7
Final domestic demand	2.0	1.8	2.4	3.4	3.4	2.7
Stockbuilding[1]	−1.1	0.0	0.0	0.0	0.0	0.0
Total domestic demand	0.8	1.9	2.5	3.4	3.4	2.7
Exports	1.4	1.2	4.8	6.0	6.4	5.5
Total demand	1.0	1.6	3.3	4.4	4.5	3.7
Imports	0.6	2.4	5.2	7.4	7.4	6.0
Net exports[1]	0.4	−0.4	0.1	−0.3	−0.1	0.1
GDP	**1.2**	**1.3**	**2.4**	**3.0**	**3.1**	**2.6**

[1] Change in percent of GDP preceding year.

Sources: Statistics Sweden and NIER.

NO DOWNTURN IN UNEMPLOYMENT UNTIL 2014

Despite rising employment in 2012, unemployment rose because of a substantial increase in the labour force (see Table 4). There will be a slight continued rise in unemployment 2013 and unemployment will not start to decrease until the end of next year (see Diagram 17). When demand begins to recover toward the end of the current year, firms will initially increase output primarily through more efficient use of existing personnel, thus restoring productivity. Hence, hiring will not pick up until resource utilization within firms has been normalized. Recovery on the labour market will take a long time. Not until 2017, when unemployment will be 6.5 percent, will cyclical balance return to the labour market.

Table 4 Labour Market

Percentage change

	2012	2013	2014	2015	2016	2017
Hours worked[1]	0.6	0.2	0.6	1.1	1.2	1.0
Employment	0.7	0.5	0.4	1.0	1.2	1.0
Labour force	0.9	0.7	0.4	0.5	0.4	0.4
Unemployment[2]	8.0	8.2	8.2	7.7	7.0	6.5

[1] Calendar-adjusted. [2] Percent of labour force.

Sources: Statistics Sweden and NIER.

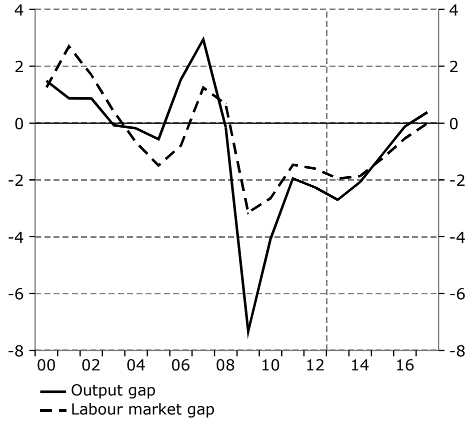
WAGE INCREASES DROPPING TO A LOWER LEVEL

For 2012, hourly earnings in the business sector are estimated to increase by 3.3 percent. This is marginally less than the average of 3.4 percent over the last decade. In the next few years wage increases will slow somewhat (see Diagram 18 and Table 5).

In 2013, central wage agreements are negotiated for the majority of Swedish employees. Labour negotiations for parties in the manufacturing sector have resulted in a three year agreement, with centrally negotiated wage increases of a little more than 2 percent per year. In 1997 the first Industrial Cooperation and Negotiation Agreement was reached. Since then the manufacturing sector has had a leading role in the labour negotiations.[4] Therefore, the agreement in the manufacturing sector is expected to set the standard for other sectors as well. The low resource utilization on the labour market means that wage increases on top of central wage agreements will be relatively modest.

Diagram 16 Output Gap and Labour Market Gap

Percent of potential GDP and of potential hours worked, respectively



Source: NIER.

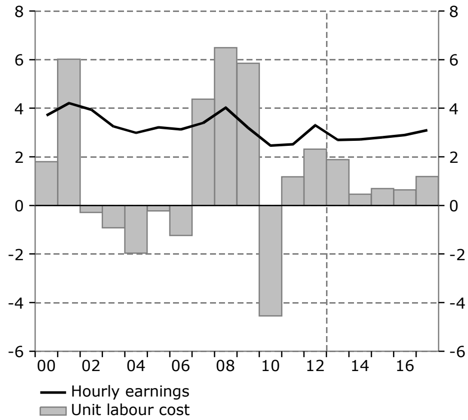
Diagram 17 Unemployment and Equilibrium Unemployment

Percent of labour force, seasonally adjusted quarterly values

Sources: Statistics Sweden and NIER.

Diagram 18 Hourly Earnings and Unit Labour Cost, Business Sector

Percentage change, calendar-adjusted values



Sources: Statistics Sweden, National Mediation Office and NIER.

[4] See "Wage Formation in Sweden 2012", NIER, for a more detailed discussion on the labour market negotiations. A summary of the report is available on www.konj.se (english version).

Table 5 Wages and Prices

Percentage change

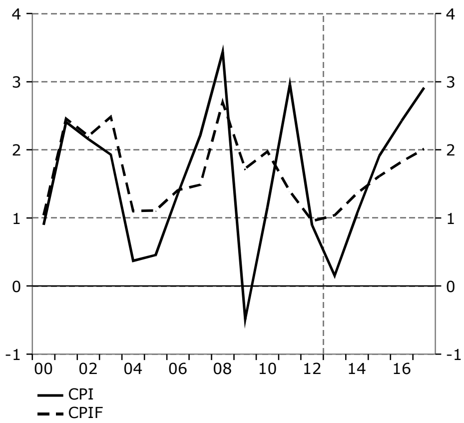
	2012	2013	2014	2015	2016	2017
Hourly earnings[1]	3.1	2.8	2.7	2.8	2.9	3.1
Hourly earnings, business sector[1]	3.3	2.7	2.7	2.8	2.9	3.1
Unit labour cost, business sector	2.3	1.9	0.5	0.7	0.6	1.2
CPI	0.9	0.2	1.1	1.9	2.4	2.9
CPIF	1.0	1.1	1.4	1.6	1.8	2.0

[1] According to Short-term Earnings Statistics.

Sources: National Mediation Office, Statistics Sweden and NIER.

Diagram 19 Consumer Prices

Percentage change



Sources: Statistics Sweden and NIER.

LOW INFLATION FOR THE NEXT FEW YEARS

Inflation as measured by the CPIF (approximately HICP)[5], that is, the CPI with a constant mortgage interest rate, has remained below the Riksbank's inflation target of 2 percent since 2010 (see Diagram 19). With the weak state of the economy in many OECD countries, the tendency of international prices has been weak as well in recent years. In combination with a strengthening of the krona, this has had a dampening effect on prices of Swedish imports. Moreover, the weak demand situation has made it harder for Swedish firms to pass on cost increases to consumers. The aggregate effect has been low inflation. This development has also led to a deterioration of the profit share in the business sector. This year the profit share, i.e. the operating surplus as a share of total value added, will fall below 39 percent, which is substantially lower than the average the last two decades of 42 percent. As the recovery proceeds, firms are expected to restore their profit shares gradually. Competition from relatively cheaper imports will tend to hold back price increases on some markets. But given the modest increases in hourly earnings, profit shares may be increased with modest price increases. All in all, this will contribute to continued low inflation for some years to come.

Not until 2017 will inflation in terms of the CPIF reach 2 percent, i.e. be in line with the Riksbanks target (see Diagram 19 and Table 5). Since the Riksbank is expected to start raising the repo rate in 2015, home mortgage interest rates will increase. This will contribute to an increase in inflation as measured by the CPI, which is affected by mortgage interest rates, so that it exceeds 2 percent in 2016–2017.

RIKSBANK TO LEAVE THE REPO RATE UNCHANGED FOR AN EXTENDED PERIOD

The Riksbank's policy rate (the so-called repo rate) is 1 percent at the present (see Diagram 20). According to NIER, the Riks-

[5] The Riksbank frequently use CPIF in its monetary policy analyses, whereas little attention is paid to HICP. Hence NIER forecast CPIF and CPI rather than HICP.

bank could lower the repo rate further for the purpose of speeding up the recovery of the Swedish economy, without risk of high inflation.[6]

The Riksbank's communication, however, suggests that a majority of its Executive Board continue to attach special importance to financial stability in their monetary policy decisions. In view of the development of household debt and housing prices, the majority of the Executive Board hold that an excessively low interest rate may increase the risk of financial imbalances, which would allegedly make it more difficult to meet monetary policy targets beyond the Riksbank's three year forecasting horizon.

Swedish real house prices, deflated by CPI, has risen substantially since the financial crisis in the early 1990's, partly as a consequence of a sharp fall in real mortgage interest rates as the new monetary policy regime (floating exchange rate and inflation targeting) gained credibility (see Diagram 21). Since 2007 prices have been fuelled by a big cut in the property tax and by the introduction of a tax reduction for expansions and reinvestments in existing privately owned homes. In recent years, however, the upward trend in real house prices appears to have been broken. House prices deflated by hourly wages are arguably likely to be more informative about household ability to finance their homes. Real house prices deflated this way have increased much less, indicating that household ability to finance their homes have not eroded that much.

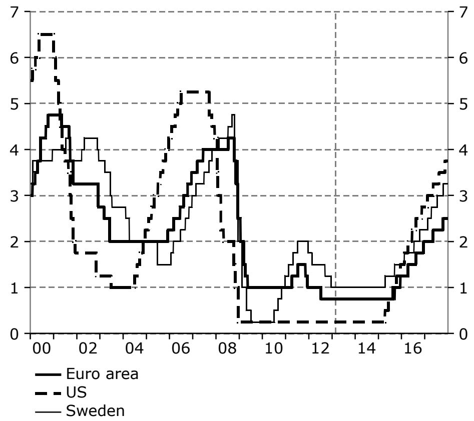
In NIER's opinion it is reasonable to assume that house prices at the present are broadly in line with fundamental determinants. According to NIER's surveys, households have realistic expectations of future short term mortgage interest rates (4.3 percent in 5 years). Moreover, there has not been a boom in residential investments, as was the case in e.g. the US, Denmark and Spain before house prices tumbled (see Diagram 22). Over the last decade (2002–2011), residential investment in Sweden amounted to 3.2 percent of GDP, while the corresponding figure for the EU was 5.5 percent of GDP. Finally, speculative tendencies on the Swedish housing market are supposedly very small, with only negligible buy-to-let elements. Obviously the NIER assessment is highly uncertain. But if house prices are to fall substantially in Sweden, the direct effect on the real economy from a fall in residential investments should be relatively limited.

As house prices have increased, so have household assets and debts (see Diagram 23). The debt ratio (debt as a share of disposable income) is now around 170 percent. This is historically high, but in recent years the debt ratio has stabilized. Total assets have increased even more and now amount to 600 percent of

[6] See the special analysis "An Even Lower Repo Rate Should Be Considered", *The Swedish Economy*, December 2012, NIER, available on www.konj.se (english version).

Diagram 20 Policy Rates

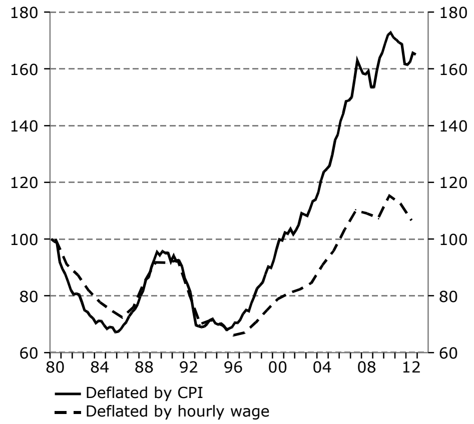
Percent, daily values



Sources: ECB, Federal Reserve, The Riksbank and NIER.

Diagram 21 Real House Prices

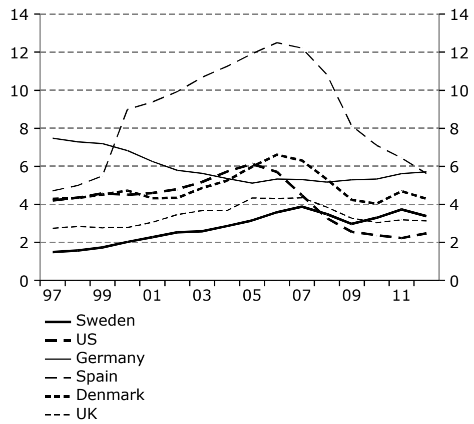
Index, quarterly values (1980q1=100) and annual values (1980=100) respectively



Sources: Statistics Sweden and NIER

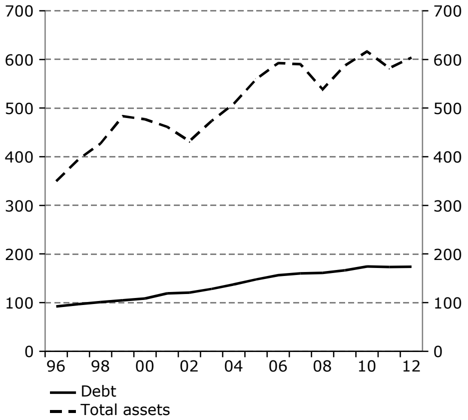
Diagram 22 Residential Investments as a Share of GDP

Percent, current prices



Sources: Statistics Sweden, NIER and National Sources

Diagram 23 Household Debts and Total Assets
Share of disposable income, percent



Sources: Statistics Sweden and NIER

Diagram 24 Government Bond Interest Rates
Percent

Note: 10-year maturity.
Sources: National sources and NIER.

disposable income, around half of it being real assets. On average, households thus have very strong balance sheets.

The flattening of the household debt ratio and real house prices in recent years is welcome. According to NIER this stabilization should make it possible for the Riksbank to lower the repo rate further in order to speed up the recovery. However, given the communication of the Riksbank, NIER's forecast does not entail any further cuts in the repo rate. The prolonged recovery will mean that monetary policy can remain expansionary for an extended period of time. To avoid overly high resource utilization later on with an inflation that exceeds the target, the Riksbank will raise the repo rate gradually beginning in the second quarter of 2015 (see Diagram 20 and Table 6). The forecast development means that resource utilization in the economy will be in balance in the latter part of 2016. At this point the repo rate will still be at a level below what has historically been considered compatible with balanced resource utilization. The reason is that interest rates in many other countries will still be very low, and that a higher rate in Sweden could give rise to a stronger exchange rate, which in turn could delay recovery and dampen inflation to an undesirably high degree. The Riksbank will thereafter raise the repo rate to 3.25 percent at the end of 2017, which is still below the assessed long-term equilibrium level of 4 percent.

VERY LOW INTEREST RATES ON GOVERNMENT BONDS

The weak tendency in recent years and the uncertain economic climate have meant that investors on financial markets have sought to transfer their investments towards less risky assets. Moreover, the bigger central banks have purchased government bonds on a large scale. In combination with low policy interest rates in several major economies, this has meant that interest rates on government bonds have fallen in many countries to levels that are extremely low by historical standards (see Diagram 24). A seemingly higher risk appetite on financial markets at the outset of 2013 has contributed to rising interest rates on government bonds in countries such as Sweden, the US and Germany. An orderly resolution of the debt crisis in the euro zone will probably contribute to continued normalization of risk appetite, thereby reducing the demand for safer, more liquid investments. When recovery also in the longer run entails a less expansionary monetary policy, with interest rate hikes in many countries, short-term interest rates will begin rising. All factors considered, this means that interest rates on long-term government bonds will increase in the next few years, with the rate on Swedish 10-year government bonds gradually rising to 4.5 percent in 2017 (see Diagram 24 and Table 6).

Table 6 Interest Rates

Percent

	2012	2013	2014	2015	2016	2017
At year-end						
Repo rate	1.00	1.00	1.00	1.50	2.25	3.25
Annual averages						
Repo rate	1.5	1.0	1.0	1.3	1.9	2.8
5-year government bond	1.1	1.8	2.7	3.5	3.9	4.3
10-year government bond	1.6	2.3	3.2	3.8	4.3	4.5

Sources: The Riksbank and NIER.

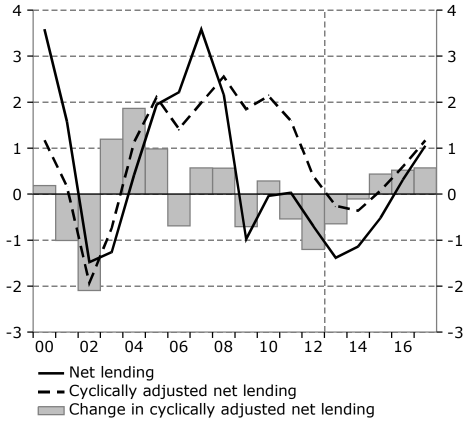
UNFUNDED MEASURES WILL CONTRIBUTE TO AN EXPANSIONARY FISCAL POLICY THIS YEAR

In the Budget Bill for 2013, there are unfunded measures equivalent to SEK 23 billion, i.e. around 0.6 percent of GDP. The proposed Spring Fiscal Policy Bill adds SEK 3 billion. In total, the net lending of the general government sector is calculated to be about –1.4 percent of GDP this year, double the amount of the deficit compared to last year. After net lending is adjusted for cyclical effects, it will be –0.3 percent of potential output this year compared to 0.4 percent last year. The decrease in cyclically adjusted net lending means that fiscal policy is given an expansionary stance this year (see Diagram 25).

For 2014 the NIER forecasts that the Government will implement a further SEK 15 billion in unfunded measures, of which the largest item is expected to consist of tax cuts for households.[7] With these unfunded measures, cyclically adjusted net lending will decrease only marginally to –0.4 percent of potential GDP. As a consequence, fiscal policy can be considered neutral next year.

Diagram 25 Net Lending and Cyclically Adjusted Net Lending, General Government Sector

Percent of GDP and of potential GDP, respectively



Sources: Statistics Sweden and NIER.

NEED FOR AUSTERITY MEASURES IN 2015–2017 IF THE PRESENT SURPLUS TARGET IS TO BE REACHED

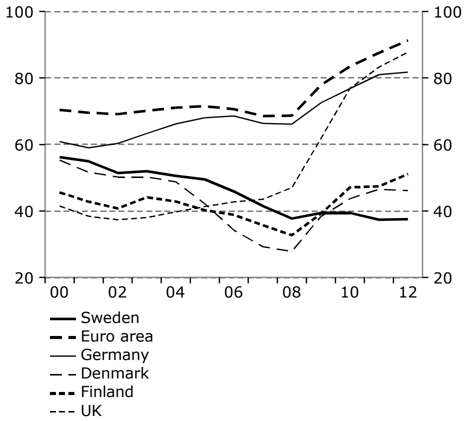
In the short run the fiscal policy forecast is governed by proposals and announcements in the Budget Bill and the Spring Fiscal Policy Bill. For coming years, when this information is not available, the fiscal policy forecasts are based on the NIER's assessment of how the fiscal policy framework will be applied. In this assessment, the surplus target for the general government is the cornerstone but the expenditure ceiling and the balanced budget requirement for the local government sector are also considered. The surplus target means that the actual net lending of general government is to average 1 percent of GDP over a business cycle.

Swedish public finances are strong in an international perspective. The government debt has been on a downward trend the last 15 years and the Maastrichtdebt was 38 percent of GDP

[7] This forecast is highly uncertain, as there are not presently any clear suggestions from the Government. The assessment is based on the NIER's interpretation of communications from different Government representatives.

Diagram 26 Maastrichtdebt

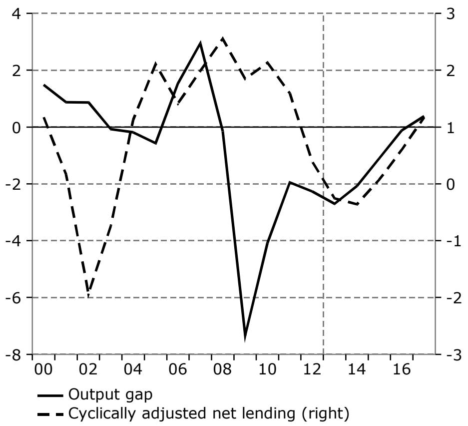
Percent of GDP



Sources: Eurostat

Diagram 27 Output Gap and Fiscal Policy

Percent of potential GDP



Source: NIER.

in 2012 (see Diagram 26). The present general government surplus target means that the downward trend in the debt ratio will continue.

The surplus target was, however, introduced in order to prepare for coming demographic challenges. In NIER's opinion the on-going turnaround in the demographic development, with an increasing share of people outside working-age, suggest that the present surplus target may be lowered to around zero percent over a business cycle. The first decade after the surplus target was introduced in 2000, net lending in the old-age pensions system was around 1 percent of GDP. In recent years, net lending in the old-age pensions system has fallen to around zero. NIER long-term forecasts indicate that net lending in the old-age pension system will stay close to zero over the coming two decades.[8] The lower net lending in the old-age pension system may according to NIER motivate a lowering of the general government surplus target. According to NIER's analyses, a lowering of the surplus target to zero would not jeopardize the long-term sustainability in public finances.[9]

NIER's forecast nevertheless assumes that the present general government surplus target will be met. In NIER's assessment this requires that the cyclically adjusted net lending must gradually rise to the level of 1.2 percent of potential GDP when the economy is in balance (see Diagram 27).[10]

With unchanged rules in the systems of taxes and transfers, the revenue of general government will increase largely at the same rate as GDP, whereas public expenditure will increase more slowly than GDP.[11] This form of automatic budget reinforcement, however, will not be sufficient to meet the surplus target. Given the forecast of unfunded measures totalling SEK 15 billion next year, there will be a need for budget-reinforcing measures totalling SEK 23 billion during 2015–2017. Note that these budget-reinforcing measures are required given the existing, largely nominal standards in public services and transfer systems. Should the Government wish to retain or improve these standards in terms of real per capita value, additional measures need to be fully financed.

The cyclically adjusted net lending in proportion to potential GDP is projected to rise from –0.4 percent in 2014 to 1.2 percent in 2017. Fiscal policy will thus be given a contractionary stance after 2014.

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[8] NIER annualy publish a report on the long-term sustainability of public finances. The report is, however, avaliable only in Swedish. See www.konj.se (swedish version) "Konjunkturinstitutets beräkning av långsiktig hållbarhet i de offentliga finanserna", Fördjupnings-PM Nr. 20, 2013.

[9] *Ibid.*

[10] See the special analysis "The Surplus Target for General Government Finances", *The Swedish Economy*, March 2013, NIER, available on www.konj.se (english version).

[11] See the special analysis "The NIER's Assessment of the Scope for Reforms", *The Swedish Economy*, March 2013, NIER, available on www.konj.se (english version).